CAUSES AND CONSEQUENCES OF U.S. DEFICITS ON TRADE AND CURRENT ACCOUNT

Introduction and Summary

The U.S. current account balance moved from a surplus of $4 billion in 1981 to a deficit of $11 billion in 1982. The deficit on merchandise trade was $28 billion in 1981 and $36 billion in 1982. The U.S. has a surplus on services which roughly balances its deficit on merchandise trade. The $11 billion 1982 current account deficit consisted of a $33 billion surplus on services and a $36 billion deficit on merchandise trade, resulting in a $3 billion deficit on goods and services, and an $8 billion deficit on grants and remittances.

Both the current account and merchandise trade account are expected to move further into deficit at least through next year. Private forecasting firms place the deficit on current account at about $50 billion and the trade deficit next year in the $70 to $80 billion range. This represents a projected slippage of about $40 billion in both accounts between 1982 and 1984. Some internal government projections run up to $20 billion higher, involving a $60 billion slippage.

There is no firm consensus among analysts as to the causes of the widening of the trade and current account deficits. To some extent, it results from the faster and more vigorous economic recovery underway in this country than among the other industrialized nations. Perhaps up to $10 billion of the increase in the trade deficit projected between 1982 and 1984 results from slower recovery abroad than here. Further, the economies of many LDC's are severely depressed because of the international debt problem and resulting austerity measures that they have adopted. U.S. exports to the nonindustrialized world in the first half of this year were down $16 billion, annual rate, from a year earlier and $23 billion from two years earlier. Most, if not all, of such declines in exports can be traced to the financial problems being faced by LDC's. Roughly $20 billion of the increase in the trade deficit projected between 1982 and 1984 can be traced to LDC financial problems. These two factors would account for three-quarters of the slippage in the accounts as estimated by private forecasts, and about half of the slippage predicted by some government forecasts.

The remainder of the projected shift in the current account and trade balances may be attributed to a capital inflow and/or a strong dollar, which have enabled U.S. consumers and businesses to purchase more goods and services from abroad, and have reduced demand for our exports. In turn, the strength of the dollar appears to be related to: (1) the marked slowing of inflation here which has made the dollar a more attractive store of value relative to other currencies; (2) political, social, and financial instabilities and uncertainties which have made the dollar a safe haven in a troubled world; (3) high real returns on investment in physical capital in the U.S. as a beneficial result of the Administration's investment incentives; and (4) high real interest rates that have drawn funds from abroad -- though the case for budget related real interest rate differentials as a cause of the strong dollar does not appear to be so clear cut as press reports might indicate.

In assessing the role of interest rate differentials, it must be remembered that the Reagan Administration program was designed to raise the real rate of return on physical capital to encourage investment in plant, equipment, and structures. This was expected to result in higher yields on financial instruments as firms shared the higher after-tax returns on investment with savers to attract funds for expansion. The reduced inflation and the improved yields on direct investment and financial instruments were expected to lead to a substantial capital inflow from abroad, possibly as much as $30 billion annually as estimated in the 1981 economic forecast. Hence, the recent developments on capital account should not have come entirely as a surprise. This $30 billion capital inflow, added to the $30 billion previously accounted for, would explain the remainder of a $60 billion shift in the current account and trade balances, and would over-explain a $40 billion shift.

In addition to the Administration program, some analysts attribute part of the current high level of real interest rates to uncertainties generated by the uneven implementation of monetary policy over the past several years -- specifically, the marked stop-go pattern in the growth of reserve and monetary aggregates since late 1979. Increased volatility of the growth rate of the money supply, interest rates and bond prices increase the risk of holding bonds and may account for 3 percentage points or more of current interest rates.

Other analysts operating in a Keynesian framework attribute much of the real interest rate differentials, the strengthening of the dollar, and the rise in the trade deficit to the Federal budget defict. A large Federal borrowing requirement has been superimposed on currently low rates of private domestic saving.

This analysis is questionable. The link between deficits and interest rates has not been established. Economic literature indicates a definite link between higher government spending and higher interest rates. Higher tax rates are also linked to higher interest rates. The deficit per se has not been systematically related to higher interest rates in serious empirical work.

Even in questionable systems of analysis which regard budget deficits as inherently stimulative, this argument is normally reserved for a full employment economy, and does not appear to be applicable at the current time. When the economy is operating at less than capacity, higher deficit spending is supposed primarily to increase domestic output and income, resulting in additional savings flows and tax revenue. However, when the economy is at capacity, higher deficit spending supposedly displaces private spending onto imports, via interest rate and exchange rate adjustments. Currently, unemployment is 9.5 percent and industrial capacity utilization is 77 percent.

Domestically, the impacts on real activity of our large projected trade and current account deficits are not readily ascertained. In part they are the result of faster U.S. growth, rather than the cause of weakness. Furthermore, insofar as the capital inflows are a response to better investment opportunities in the U.S., they would allow additional imports as a supplement to rather than as a substitute for domestic output. The capital inflows to the United States, which are the other side of the coin of current account deficit, will permit interest rates to be lower here than they otherwise would be, preserving jobs in interest rate sensitive industries and allow more capital formation than otherwise would be the case.

Nonetheless, there may be some short-term losses in real output and employment in export or import competing industries. However, not all of the current difficulties experienced by industries competing with foreign firms can be traced to what may be temporary disturbances in international trade balances and capital flows. Declines in many instances are part of the ongoing process of shifting comparative advantage and increasing international specialization, a process that has been an important factor in world-wide growth in standards of living.

The United States should move cautiously in taking any measures designed to deal directly with balance of payments deficits:

- The large current account and trade deficits projected for this country will help permit renewed growth of export earnings by LDC's, allowing them to service debts without depressing their economies still further from already low levels of performance. The deficits would also strengthen economic recovery in the developed world, enhancing U.S. exports.

- Any adverse impact on LDC exports, which would be an inevitable consequence of tariffs, quotas, or slower growth of the U.S. economy, would further worsen the LDC debt servicing problem. Demands on the IMF and other multinational lending institutions would certainly increase. Domestically, there would be adverse consequences for U.S. exports, the U.S. banking system, and interest-sensitive sectors such as autos and homebuilding.

- Tax increases would affect all sectors of the economy, increasing the cost of U.S. labor and capital, and cutting U.S. exports and real growth rates.

There is one clear step the United States can take which would not conflict with the tax and regulatory initiatives designed to make U.S. labor and capital more competitive in the world. A reduction in government spending over time as a share of GNP would unambiguously reduce interest rates and would curtail government absorption of both financial resources and domestic output. This would result in a healthier domestic economy and an improved balance of payments picture.

Review of the Trade and Current Account Balances

The current account balance represents the balance on all international transactions including trade of goods and services, earnings from foreign investments, military and other government grants, and transfer payments, such as those made for pensions to foreigners or by private individuals to foreign relatives. In 1982, a large deficit on merchandise trade was in part offset by a positive balance on trade in services. (The category "other goods and services" shown below contains a very small balance on military transactions, but the largest portion of the category is services such as travel, insurance, or the services of capital, such as dividends and interest.)

Components of U.S. Current Account Balance in 1982

		Billions of dollars
Trade (total goods and services)		-3.2
Merchandise	-36.4	
Other goods and services	+33.2	
U.S. Government grants		-5.4
Remittances, pensions, and transfers		-2.6
Total current account balance		-11.2